

State Regulation of Insider Trading—A Timely Resurgence?

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I. INTRODUCTION

Today is a time of "insider trading"¹ and a time of concern about "insider trading."² For the "insider trader,"³ such as Gordon Gekko,⁴ today is perhaps not the best of times, but certainly in light of the Supreme Court's decisions in *Chiarella*⁵ and *Dirks*,⁶ it is the better of times. For the Securities and Exchange Commission (the "Commission") and those investors who trade without knowledge of so-called "inside information,"⁷ today is perhaps not the worst of times, but a worse time, at least with respect to a possible remedy under the federal securities laws.⁸

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1. A flurry of insider trading articles has appeared in the literature. For example, from August 20, 1986, to August 20, 1987, the *Wall Street Journal* published over 340 articles on that subject.

2. The most recent vacancy in the Securities and Exchange Commission (the "Commission") resulted in President Reagan's appointing Professor David Ruder, an outspoken opponent of insider trading. Ingersoll & Seib, *SEC's Drive Against Insider Trading To Be Pressed by Ruder, Reagan Vows*, *Wall St. J.*, June 18, 1987, at 3, col. 2. Congressional concern about insider trading is found in its most recently enacted law on the subject. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified at 15 U.S.C. §§ 78a, 78c, 78o, 78t, 78u, and 78ff). For discussion of the Act, see Comment, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*, 73 CAL. L. REV. 483 (1985) [hereinafter Comment, *Inside Information and Outside Traders*]; and Note, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455 (1985) [hereinafter Note, *A Critique of the Insider Trading Sanctions Act*]. Section 21(d)(2)(A) gives the Commission authority to seek treble damages in certain situations; the recovered funds are paid to the U.S. Treasury. 15 U.S.C. § 78u(d)(2) (1982 & Supp. IV 1986). See generally Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273 (1984); Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960; Note, *Treble Damages, Deterrence, and Their Relation to Substantive Law: Ramifications of the Insider Trading Sanctions Act of 1984*, 20 VAL. U.L. REV. 575 (1986).

3. For the purpose of this Article, an "insider trader" is any person who buys or sells securities with knowledge of material nonpublic information but who does not disclose that information. See *infra* notes 20–26 and accompanying text.

4. Gordon Gekko is the fictional villain in the popular movie "Wall Street." While he is an insider trader under the definition of this Article, he may not be liable for some of his trading given the recent Supreme Court decisions because he may have had in some cases no duty to disclose. See *infra* notes 119–41 and accompanying text.

5. *Chiarella v. United States*, 445 U.S. 222 (1980). For discussion of this case, see *infra* notes 119–34 and accompanying text.

6. *Dirks v. SEC*, 463 U.S. 646 (1983). For discussion of this case, see *infra* notes 135–41 and accompanying text.

7. For the purposes of this Article, "inside information" is defined as any kind of information not available to the public.

8. The federal securities laws, especially § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), provide remedies for some types of insider trading. The Commission has taken the view that insider trading by a select group of individuals with nonpublic information destroys the integrity of the markets and has utilized rule 10b-5 to regulate people who trade on such confidential inside information. See generally Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307 (1981); Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

Yet today is in another sense a different time with respect to "insider trading." In *Chiarella* and in *Dirks* the Supreme Court tied liability under section 10(b)⁹ of the Securities Exchange Act of 1934 (the "Exchange Act")¹⁰ and rule 10b-5¹¹ to some duty to disclose or refrain from trading or tipping.¹² That duty, at least in the case of traditional insiders,¹³ and perhaps their tippees,¹⁴ lies in the common law; and, given the realities of today's world of corporations, it lies largely in the law of Delaware and a few other key commercial states.¹⁵

Accordingly, this Article will examine the common law regulation of "insider trading," the beginnings, the period of evolution, the period of unfortunate de facto federal preemption, and finally the present period of necessary and appropriate resurgence. The future regulation of "insider trading," absent some rather substantial legislation from Congress,¹⁶ lies to a great extent in the further judicial development of the common law of fiduciary duty owed by directors, officers, key employees, and perhaps some others to their corporations. The evolution began, it was interrupted, but it is today again "on the move." State law regulation of the problem is inevitable.¹⁷ More important, the duty of "insiders" with respect to disclosure is presently an expanding duty.¹⁸ Indeed, the trend of state court decisions, particularly those of the Delaware Supreme Court, on the scope of fiduciary duties, including the duty not to

9. 15 U.S.C. § 78j (1982).

10. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-78kk (1982)).

11. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1987).

12. *Chiarella v. United States*, 445 U.S. 222, 231 (1980); *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

13. For the purposes of this Article, traditional insiders are directors, officers, and key employees. *See generally* *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949) (a confidential secretary to an officer and director was liable for a breach of his fiduciary obligation to the corporation when he traded without disclosing confidential information).

14. A "tippee" is one who receives nonpublic inside information from a tipper. The "tipper," of course, is the person, who by the nature of his position, possesses material inside information and who selectively discloses it. Although liability has been extended to tippees, liability is limited, and requires the tippee to know or have reason to know of the tipper's breach. *See generally* 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 6 (1987).

15. An examination of those companies listed on the New York Stock Exchange reveals that a substantial minority (approximately 46%) of the corporations are incorporated in Delaware. 1 N.Y.S.E. Guide (CCH) 725-801 (1987). Additionally, New York, New Jersey, Massachusetts, California, Texas, and Ohio have a notable number of businesses incorporated in their states as well. *Id.* For this reason, Delaware court decisions, and court decisions from the other above-mentioned states, have a profound effect on the development of the corporate law, both judicial and statutory.

16. The Commission has included a proposed legislative definition of insider trading in one of its latest attempts to amend the Exchange Act. The submitted proposal now being reviewed by the Senate Banking Subcommittee on Securities is known as the Insider Trading Proscriptions Act of 1987. *See* Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373 (1988).

17. *See generally* Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 WASH. & LEE L. REV. 845 (1982). Professor Hazen contends that the state's role was to fill the gaps in the federal regulation of insider trading. *Id.* at 847. Professor Hazen's point is well taken; however, it is the contention of this author that later case development since 1982 (*i.e.*, *Dirks*) has not only reawakened the common law, but will result in state common law surpassing the federal law as the primary means of attacking insider trading.

18. This duty is particularly significant in recent Delaware cases. *See infra* notes 167-80 and accompanying text.

trade without complete and correct disclosure, suggests that state common law will now provide the most appropriate and effective regulation of "insider trading."

II. THE MEANING OF "INSIDER TRADING"

The extent to which "insider trading" is or should be regulated has been the subject of endless commentary.¹⁹ Any meaningful consideration of that issue, however, presumes some understanding of what activities constitute "insider trading." Although the term has become almost a household word, its meaning is in fact elusive, even confusing, rather than precise.

While the meaning of trading is crystal clear, including both the purchasing and selling of securities,²⁰ normally through a broker-dealer²¹ over an exchange or over-the-counter, the significance of the term "insider" or "inside" is otherwise. In reality that adjective is sometimes used to describe the undisclosed information involved. In other words, nonpublic information is frequently referred to as "inside information." Presumably, then, "insider trading" could mean any trading by any person who happens to be aware of and fails to disclose such nonpublic information either about the issuer of the securities involved or about the market. Alternatively, the phrase "insider trading" could mean trading on the basis of such nonpublic

19. For articles in favor of the prohibition of insider trading, see generally Brudney, *supra* note 8; Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628; Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980). For commentaries criticizing the prohibition of insider trading, see generally H. MANNE, *INSIDER TRADING AND THE STOCK MARKETS* (1966); Carlton & Fischel, *supra* note 8; Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

20. Section 3(a)(10) of the Exchange Act defines a security as:

[A]ny note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1982). It should be noted that the definition of security, despite its seemingly extensive definition in the Exchange Act, has been "elusive." See generally Schneider, *The Elusive Definition of a Security*, 14 REV. SEC. REG. 981 (1981), and its updates, Schneider, *Developments in Defining a "Security,"* 16 REV. SEC. REG. 985 (1983), and Schneider, *Definition of a "Security"-1983/1984 Update*, 17 REV. SEC. REG. 851 (1984), for summaries of the elusiveness of the definition of the term "security" under the Securities Act of 1933 (the "Securities Act") and the Exchange Act.

21. "Broker" is defined as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Securities Exchange Act of 1934, § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1982). "Dealer" is defined as:

[A]ny person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

Id. § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1982). For the purposes of this Article, the dichotomy between broker and dealer is irrelevant; thus the general term broker-dealer will be used throughout.

information if, but only if, the trader is an "insider"²² within the meaning of the applicable regulations.

Although consideration of the provisions of the federal regulatory scheme that relate to trading in reliance upon information not publicly available would provide a basis for either definition of "insider trading,"²³ this Article will regard "insider trading" as any trading by any person who is aware of, but fails to publicly disclose, nonpublic information that is material to the transaction.²⁴ In terms of the federal regulatory scheme, this broader definition is more consistent with the primary purpose of the securities laws, that is to protect investors by requiring, encouraging, or otherwise facilitating the maximum amount of timely disclosure of all material information.²⁵ It is also more consistent with the language of section 10(b) of the Exchange Act and rule 10b-5, the primary bases for federal regulation of "insider trading," since they purport to apply to "any person" rather than to any specific category or categories of persons.²⁶

III. THE REGULATORY PROBLEMS

The regulation of insider trading, to the extent that it has been or is presently regulated, stems from several sources, both federal and state, of both statutory and common law origins. For the last two decades,²⁷ the Exchange Act's general antifraud provision contained in section 10(b) and its enabling rule 10b-5 have been the source of virtually all enforcement actions against persons trading on nonpublic information, actions brought often by the Commission,²⁸ but perhaps more often by

22. Such a definition is supplied in § 16 of the Exchange Act, 15 U.S.C. § 78p (1982). This section applies to officers and directors of issuers having a class of equity securities registered pursuant to § 12 of the Exchange Act and to beneficial owners of more than 10% of any class of registered equity securities. 15 U.S.C. § 78p(a) (1982). Under § 16(b), the corporation or a shareholder, on behalf of the corporation, may recover profits gained by such insiders regardless of whether they traded the corporation's securities on the basis of inside information. Section 16 applies to any purchase and sale, or sale and purchase, within a six-month period, regardless of intent. 15 U.S.C. § 78p(b) (1982).

23. In enacting § 16 of the Exchange Act, Congress intended to prevent traditional corporate insiders from trading on inside information. *See generally* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). This section, however, does not include everyone who may have a fiduciary duty to the corporation; thus, the reach of the section is limited.

24. *See generally* TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976). An omitted fact is material under rule 14a-9 of the Exchange Act, 17 C.F.R. § 240.14a-9 (1987), "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449. Although TSC addresses materiality under § 14(a) of the Exchange Act, the test for materiality is the same under all securities statutes. *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 919-20 (8th Cir. 1977). For cases applying the TSC definition of materiality to § 10(b) actions, see *Austin v. Loftsgaarden*, 675 F.2d 168, 176 n.17 (8th Cir. 1982); *Bell v. Cameron Meadows Land Co.*, 669 F.2d 1278, 1281 (9th Cir. 1982).

25. Senate Committee on Banking and Currency, S. REP. NO. 47, 73d Cong., 1st Sess. (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 17 (comp. by J.S. Ellenberger & E. Mahar 1973).

26. *See supra* note 11.

27. Since the Second Circuit's 1968 decision in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), the scope and remedies under rule 10b-5 have been used extensively to attack insider trading. *See infra* notes 71-85 and accompanying text.

28. Section 21 of the Exchange Act gives the Commission authority to investigate violations of that Act or the rules and regulations promulgated thereunder. 15 U.S.C. § 78u (1982). The first critical example of the Commission exercising its right against insider trading was in *Texas Gulf Sulphur*. Since then, the Commission has brought numerous actions against various insider traders. *See, e.g.*, *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983) (board chairman of a real estate investment trust violated the antifraud rules by failing to disclose inside information of a possible long-term lease); *SEC v. Fox*, 654 F. Supp. 781 (N.D. Tex. 1986) (employees of corporation did not possess material inside information and

defrauded purchasers or sellers of securities.²⁹ As described and explained below,³⁰ the scope of that cause of action appeared for a time broad enough to make unlawful any trading based on nonpublic information by any person who happened to possess it,³¹ even when that trading person acted only negligently rather than with actual intent to defraud.³² In other words, it appeared for a time that section 10(b) and rule 10b-5 rendered unlawful all insider trading as above defined. Accordingly, although the blue sky laws of most, if not all, states contained general antifraud provisions similar to the federal provisions,³³ they were generally ignored, in large part because of the procedural advantages available under the federal act.³⁴

Recently the Supreme Court has in several ways narrowed the scope of section 10(b) and rule 10b-5.³⁵ The most critical of those narrowing interpretations respecting the extent to which insider trading is a violation of the Exchange Act are those cases, specifically *Chiarella* and *Dirks*, in which the Court has said that a person may

thus had no duty to disclose); *SEC v. Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986) (profits disgorged from temporary insider involving a tender offer under the misappropriation theory); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) (manager of office services department of law firm disclosed nonpublic material information concerning firm's corporate clients); *In re Certain Trading in the Common Stock of Faberge, Inc.*, 45 S.E.C. 249 (1973) (Commission obtains consent decree for alleged insider trading).

29. A federal district court first implied a private right of action under rule 10b-5 in 1946. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The U.S. Supreme Court's first explicit recognition of rule 10b-5's status in private litigation was in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). Although the 1970s saw expansive treatment of implied rights of action, the *Bankers Life* Court never suggested it would continue expanding implied rights. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court reviewed standing considerations in rule 10b-5 damage actions; and in a later case, it scaled back implied rights of action under 10b-5, requiring that the complained of conduct be "deceptive." *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (no cause of action for shareholders squeezed out in an allegedly unfair short-form merger absent deceptive or manipulative conduct).

30. See *infra* notes 71-85 and accompanying text.

31. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236-37 (2d Cir. 1974) (tipplers who possessed material, nonpublic information about a company and failed to disclose that information when they traded were liable despite no express finding of any fiduciary duty).

32. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 863 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Various circuits had discarded the scienter requirement for damages under rule 10b-5. *Id.* at 868 (Friendly, J., concurring). The Supreme Court, however, has since made clear that scienter is a requirement. See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

33. Many states have enacted blue sky laws that embrace the underlying theme of rule 10b-5. Although a general examination of blue sky laws is beyond the scope of this Article, it is important to note the similarity between rule 10b-5 and state law. Many states have adopted the Uniform Securities Act in some form. Section 101 is patterned after rule 10b-5 and prohibits fraudulent and other practices:

In connection with an offer to sell, sale, offer to purchase, or purchase, of a security, a person may not directly or indirectly:

- (1) employ a device, scheme, or artifice to defraud;
- (2) make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, in light of the circumstances under which they are made; or
- (3) engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

Uniform Securities Act § 501 (1985). Section 609 specifically bars implied rights of action under this Act, thus limiting its effectiveness. See *Mid-Continent Casualty Co. v. McAlester Aircraft, Inc.*, 349 F.2d 885 (10th Cir. 1965). See also *Ratner, Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947 (1976).

34. "Rule 10b-5 allows for a broad choice of venue, world wide service of process, freedom from security for expense requirement, and pendent jurisdiction over state causes of action." Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73, 78 n.37 (1986) (citing W. CARY & M. EISENBERG, CORPORATIONS 841-44 (5th ed. 1980)).

35. See generally *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Court adopted the *Birnbaum* rule: to have standing to bring an action under rule 10b-5, one must be either a purchaser or a seller in a securities transaction. Thus, a potential purchaser was barred from recovery. See also *supra* note 29.

lawfully trade without disclosing nonpublic information unless he has an affirmative duty to disclose.³⁶ The possible sources of such a duty remain to be developed, but among them is certainly any fiduciary duty owed by the trader to the corporation or its shareholders under the applicable state common law.

Ironically, the extent to which a traditional insider trader can presently be regulated under federal law depends largely on the extent to which that person is subject to some fiduciary duty to disclose or refrain from realizing personal benefits from his fiduciary relationship under state law. Normally only if such a person, because he is a director, an officer, an employee or otherwise, owes a fiduciary duty to disclose to the corporation or its shareholders will the Commission or a defrauded investor be able to establish a federal law violation.

At the same time, if such a fiduciary duty to disclose exists, the persons to whom the duty is owed, *i.e.*, the corporation or its shareholders, will have a state law cause of action for breach of the duty. Indeed, the state law cause of action may well be broader than that under rule 10b-5 in that a fiduciary is likely to be held to a standard of intrinsic fairness³⁷ rather than of scienter.³⁸ The burden of proof may be on the fiduciary rather than on the plaintiff.³⁹ Finally, if the duty is owed to the corporation, regulation of insider trading, at least by traditional insiders and perhaps their tippees, will be possible through shareholder derivative suits,⁴⁰ by persons who in fact normally have no standing to utilize the federal remedy.⁴¹ If, then, insider trading engaged in by traditional insiders is to be effectively regulated over the next several years, it will be because the state courts revive, endorse, and perhaps expand the long controversial and innovative approach of *Diamond v. Oreamuno*,⁴² which held that officers and directors of a New York corporation are accountable to that corporation for any profits resulting from their trading in reliance on material inside information.⁴³

36. *Chiarella v. United States*, 445 U.S. 222, 235 (1980); *Dirks v. SEC*, 463 U.S. 646, 656 (1983).

37. *See, e.g.*, *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

38. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976). "[T]he term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.* at 194 n.12. The *Hochfelder* Court did not address the question as to when reckless behavior would be enough for liability under § 10(b) and rule 10b-5.

39. The burden of proof is usually on the plaintiff; however, if the fiduciary's act involves a conflict of interest, the burden of proof shifts to the fiduciary. Nearly two-thirds of the states have currently codified the common law in statutes controlling conflicts of interest transactions. E. BRODSKY & M.P. ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS* § 3.02 (1984 & Supp. 1987). Some states require the transaction to be "just and reasonable" (*e.g.*, CAL. CORP. CODE ANN. § 310(a)(3)), while others have a "fair and reasonable" test (*e.g.*, N.Y. BUS. CORP. LAW § 713(b)). Delaware case law has firmly developed the fair and reasonable line of reasoning. *See generally* *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

40. *Black's Law Dictionary* defines a "derivative suit" as an action based "upon a primary right of the corporation, but is asserted on [the corporation's] behalf by the stockholders because of the corporation's failure, deliberate or otherwise, to act upon the primary right." *BLACK'S LAW DICTIONARY* 399 (5th ed. 1979).

41. *See supra* note 35 and *infra* note 87.

42. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

43. *Id.* at 498-99, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

IV. THE DEVELOPMENT OF THE COMMON LAW REGULATION

The relationship between a corporation and its directors and officers is of more than an agency nature. It is of a fiduciary nature.⁴⁴ Traditionally, directors and officers had a duty to exercise reasonable care in managing the business and affairs of the corporation.⁴⁵ In addition, they have had a duty to act solely in the best interests of the corporation rather than in their own best interests.⁴⁶ In the past, those duties did not include any requirement that an officer or director disclose material nonpublic information prior to trading in the corporation's securities.⁴⁷ Today, however, the courts are moving in the direction of creating and substantially expanding the duties of officers and directors to disclose material information in more circumstances, including cases of insider trading.⁴⁸

A. *The Time of Beginnings*

Under what has been referred to as the "majority rule,"⁴⁹ an officer or director owed no duty to disclose any information even when the trading transaction was with an existing shareholder. In the case of *Goodwin v. Agassiz*,⁵⁰ for example, the court refused to provide a remedy for shareholders who sold their shares to certain directors of the corporation who were aware of the possible existence of valuable copper deposits.⁵¹ Yet, long before even the promulgation of rule 10b-5,⁵² the majority rule had been effectively rendered a minority position by two developments.⁵³

First, a substantial number of states adopted the "special facts" doctrine, first articulated by the Supreme Court in 1909 in the landmark case of *Strong v. Repide*.⁵⁴ Under that approach, officers and directors have had an affirmative duty to disclose nonpublic information when, in a face-to-face transaction, special circumstances or

44. In equity, a director owes the corporation complete loyalty, honesty, and good faith. The director's first duty is to act wholly for the benefit of the corporation. This fiduciary duty forbids the director from placing himself in a position where his individual interest clashes with his duty to the corporation. 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838 (perm. ed. 1986 & Supp. 1987).

45. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (Delaware law); *General Rubber Co. v. Benedict*, 215 N.Y. 18, 109 N.E. 96 (1915) (New York law).

46. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Fontheim v. Walker*, 282 A.D. 373, 122 N.Y.S.2d 642 (1953).

47. *Carpenter v. Danforth*, 52 Barb. 581, 590 (N.Y. 1868) (no evidence of a false representation of a material fact that induced the sale; nothing was done by the director to deceive the shareholder into purchasing the securities).

48. See *infra* notes 165-80 and accompanying text.

49. The "majority rule" originated in England. *Percival v. Wright*, 2 Ch. 421 (1902); see generally Loss, *The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States*, 33 MOD. L. REV. 34 (1970).

50. 283 Mass. 358, 186 N.E. 659 (1933). Although the directors of a commercial corporation stand in a relation of trust to the corporation and are bound to exercise the strictest good faith in respect to its property and business, the directors do not accept a position of trust toward individual shareholders of the corporation. *Id.* at 361, 186 N.E. at 660.

51. *Id.* at 363-64, 186 N.E. at 661. The court emphasized that the possibility of significant copper deposits was at the time still somewhat speculative.

52. Rule 10b-5 was promulgated in 1942. For the circumstances surrounding its adoption, see L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 820-29 (1984).

53. In fact, there is indication that the "majority rule" has been applied in pure form in only a handful of cases during the last thirty years. See 3 L. LOSS, SECURITIES REGULATION 1448 n.8 (1961).

54. 213 U.S. 419 (1909). Indeed, as early as 1937, one commentator suggested that the "special facts" doctrine had become the majority (or at least the plurality) approach. Lake, *The Use for Personal Profit of Knowledge Gained While a Director*, 9 MISS. L.J. 427, 448-49 (1937).

special facts render nondisclosure unconscionable.⁵⁵ Second, several jurisdictions went so far as to require disclosure of nonpublic information to shareholders in all face-to-face transactions irrespective of any special facts or circumstances.⁵⁶ As a result of these two early common law developments, officers and directors in most jurisdictions have had an affirmative duty to disclose or refrain from trading, at least in face-to-face transactions. Any breach of that duty has been actionable, however, only by the defrauded shareholder, at least until some courts began to allow corporations to recover fiduciaries' profits through derivative suits.

B. *The Time of Evolution*

If a fiduciary breaches his duty to individual shareholders by trading with them without disclosing material inside information, it would seem that such activities would also constitute a breach of duty to the corporation itself. Yet, that issue and the appropriate remedy for such a breach of duty were simply not addressed by any court until 1949.

In the case of *Brophy v. Cities Service Co.*,⁵⁷ the Delaware Court of Chancery first recognized a cause of action for the corporation for the recovery of insider trading profits. The defendant Kennedy in *Brophy* "was employed in an 'executive capacity' and as 'confidential secretary' to . . . a director and officer of Cities Service Company."⁵⁸ By reason of this position, he discovered that Cities Service intended to purchase its own shares on the market in quantities sufficient to cause the price to rise. Based on this information, Kennedy purchased a block of stock and resold it at a substantial profit following the anticipated purchases by Cities Service. The court first determined that Kennedy was a fiduciary with a duty not to use confidential information for his own personal gain.⁵⁹ It then went on to emphasize that given the equitable nature of the suit, the corporation was entitled to recover Kennedy's profits whether or not the corporation actually suffered any loss.⁶⁰ While *Brophy* contains some references to the law of trusts and the law of restitution,⁶¹ it can and should be viewed as a significant expansion of a fiduciary's duty of loyalty to the corporation.⁶²

55. In *Strong v. Repide*, a purchase of stock was rescinded when the general manager and a controlling shareholder of the corporation failed to disclose that some of the corporation's land was likely to be sold for a very favorable price. *Strong v. Repide*, 213 U.S. 419, 431 (1909).

56. See, e.g., *Taylor v. Wright*, 69 Cal. App. 2d 371, 159 P.2d 980 (1945); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932); *Stewart v. Harris*, 69 Kan. 498, 77 P. 277 (1904); *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903).

57. 31 Del. Ch. 241, 70 A.2d 5 (1949).

58. *Id.* at 243, 70 A.2d at 7.

59. *Id.* at 244, 70 A.2d at 7.

60. *Id.* at 247, 70 A.2d at 8. Despite the court's emphasis, it should be noted that the corporation indeed may have been harmed. Presumably Kennedy's purchase of a large block of stock caused some increase in the market price, making the corporation's purchases more costly.

61. The *Brophy* court based part of its opinion on the law of trusts and the law of restitution to bolster its conclusion that "if an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position of trust and confidence toward it, analogous in most respects to that of a fiduciary, and must govern his actions accordingly." *Id.* at 244, 70 A.2d at 7.

62. Although the unequivocal language of the court supports this view, it can be argued that Kennedy's breach was in fact merely competing with the corporation to obtain available shares. If that analysis is correct, the case represents no breakthrough as a fiduciary has long been liable for either competing directly with the corporation or usurping a corporate opportunity. See generally *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939) (the president of a corporation engaged in the

Although *Brophy* was a change in the common law, it was of little consequence until the New York Court of Appeals relied on it heavily to decide *Diamond v. Oreamuno*⁶³ in 1969. *Diamond* involved a typical insider trading fact pattern. The defendants included Oreamuno, chairman of the board of directors of Management Assistance, Inc. ("MAI") and Gonzalez, its president. Through their positions Oreamuno and Gonzalez became aware that MAI had suffered a substantial decrease in earnings. Knowing that the price of the stock would be adversely affected by the publication of that information, Oreamuno and Gonzalez sold 56,000 shares of MAI stock at \$28 per share. Immediately following the disclosure of the bad news, the price fell to \$11. The court held that the corporation was entitled to \$800,000, essentially the loss avoided by the two insiders.

The New York Court of Appeals held squarely that the use of confidential information for personal gain constituted a breach of the fiduciary duties owed to a New York corporation irrespective of whether the corporation was a party to the transaction and even if the corporation suffered no harm.⁶⁴ Unfortunately for the future of the *Diamond* approach in other courts, at least until recently,⁶⁵ the court went on to justify its position by adding policy arguments that have instead been used to undercut the primary analysis.⁶⁶ First, the court noted that the corporation may well have suffered harm, for example, to its reputation.⁶⁷ Second, the court suggested that its approach could be justified in part because the federal remedies were an inadequate deterrent to insider trading.⁶⁸ Indeed, the court's unreasonable concern with the possibility of preemption suggests that one reason for the *Diamond* approach was to fill a gap.⁶⁹ When the perceived gap appeared to be filled by the expanding federal law spurred by the seminal decision of the Court of Appeals for the Second Circuit in *SEC v. Texas Gulf Sulphur*,⁷⁰ the *Diamond* rationale was effectively put on the "back burner."

manufacture and sale of candies, syrups, and beverages had obtained Pepsi's secret formula and trademark, but did not make it available to his corporation). *Guth* makes it clear that one who is "entrusted with the active management of a corporation . . . may not exploit his position as an 'insider' by appropriating to himself a business opportunity properly belonging to the corporation." *Miller v. Miller*, 301 Minn. 207, 219, 222 N.W.2d 71, 78 (1974).

63. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

64. *Id.* at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

65. See *infra* notes 90-113 and accompanying text. Although the approach was heavily criticized by certain courts for almost twenty years, it was received favorably by a substantial number of commentators. Wimberly, *Corporate Recovery of Insider Trading Profits at Common Law*, 8 CORP. L. REV. 197, 200-01 (1985). The cases are praised for their progressive views concerning fiduciary responsibilities. See generally Note, *Common Law Corporate Recovery for Trading on Non-Public Information*, 74 COLUM. L. REV. 269 (1974) [hereinafter Note, *Common Law Corporate Recovery*]; Recent Cases, *Corporations: Diamond v. Oreamuno*, 83 HARV. L. REV. 1421 (1970); Recent Decision, *Corporations-Derivative Actions-Officers and Directors Are Accountable for Personal Profits from Company Stock Sold on the Basis of Inside Information*, 55 VA. L. REV. 1520 (1969).

66. See *infra* text accompanying notes 86-111. For a very recent solid endorsement of the approach, however, see *In re Orfa Secs. Litig.*, 654 F. Supp. 1449 (D.N.J. 1987). For a discussion of that case, see *infra* text accompanying notes 150-57.

67. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 499, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81-82 (1969).

68. *Id.* at 503, 248 N.E.2d at 915, 301 N.Y.S.2d at 85.

69. As the court notes, "Congress expressly provided against any implication that it intended to pre-empt the field . . . in section 28(a) of the [Exchange Act]." *Id.* at 504, 248 N.E.2d at 915, 301 N.Y.S.2d at 85.

70. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

C. The Time of Dormancy

Although the federal regulation of insider trading began theoretically with the promulgation of rule 10b-5 in 1942,⁷¹ it evolved gingerly much as had the state common law as described above⁷² until the Commission stepped in to curb the practice. In deciding *In re Cady, Roberts & Co.*,⁷³ the Commission ruled that a broker-dealer who received nonpublic information about an imminent dividend decrease from a director of the corporation violated section 10(b) and rule 10b-5 by selling stock of that corporation for himself and his customers in the absence of disclosure.⁷⁴ The basis for that 1961 ruling was that the tippee broker-dealer acquired a duty to disclose or refrain from trading from the tipper director who, according to the opinion, was clearly subject to such a duty.⁷⁵ *Cady, Roberts* was the first instance in which rule 10b-5 was applied to stock exchange rather than face-to-face transactions.⁷⁶ Since it was an administrative proceeding against a regulated broker-dealer, however, its significance in terms of foreshadowing an increasingly expansive interpretation of rule 10b-5 to regulate insider trading was then doubtful.⁷⁷

On August 13, 1968, less than a year before the *Diamond* decision, the Second Circuit eliminated all such doubt when it decided the second of the Commission's enforcement actions against insider traders. The facts in *SEC v. Texas Gulf Sulphur*,⁷⁸ interestingly, were reminiscent of *Goodwin v. Agassiz*⁷⁹ discussed above. Again, several of Texas Gulf's officers, directors, and executive employees acquired knowledge of the corporation's discovery of valuable mineral deposits and without disclosing such confidential information both made substantial purchases of Texas Gulf shares over various stock exchanges and tipped others who in turn made such purchases. Not only did the court establish that rule 10b-5 prohibited insider trading by holding several of the individual defendants liable, but it went on to explain that the rule requires that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . , must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."⁸⁰ Its stated rationale for this expansive interpretation, going well beyond traditional fiduciary concepts, was that the policy

71. Section 10(b) makes unlawful only such manipulative or deceptive acts as are "in contravention of such rules and regulations as the Commission may prescribe" 15 U.S.C. § 78j (1982). In the absence of an appropriate rule, i.e., rule 10b-5, § 10(b) could simply not be the basis for insider trading or any other liability.

72. There were a number of cases brought under rule 10b-5 by purchasers or sellers of securities against fiduciaries who traded on inside information. Like the state law cases, they all involved face-to-face transactions. See R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 1043 (6th ed. 1987). For a list of those early cases, see *id.* at 1043 n.1. See also *Hazen*, *supra* note 17, at 847.

73. 40 S.E.C. 907 (1961).

74. *Id.* at 911.

75. *Id.* at 912.

76. See *supra* note 72.

77. Note, *A Critique of the Insider Trading Sanctions Act*, *supra* note 2, at 461.

78. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

79. 283 Mass. 358, 186 N.E. 659 (1933). See *supra* text accompanying notes 50-51.

80. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The court, however, recognized that disclosure would have constituted a breach of the duty to keep silent in order to facilitate the corporation's land acquisition program. *Id.* at 874. Accordingly, the only lawful option was to abstain from trading.

underlying rule 10b-5 was that all investors justifiably expect to have equal access to material information.⁸¹

The *Texas Gulf Sulphur* decision and the numerous insider trading cases that followed⁸² provided until recently a powerful weapon for enforcement actions by the Commission and an extremely broad private right of action for defrauded investors against all persons who violated the disclose or abstain rule, including those who traded, those who tipped but did not trade, and all tippees.⁸³ As a result, the evolution of the common law regulation of insider trading, while not technically preempted,⁸⁴ was in the words of one commentator "aborted."⁸⁵

While the development of a common law remedy for an investor defrauded by an insider trader was effectively superseded by the blossoming federal law,⁸⁶ the *Diamond* approach to insider trading with its remedy for the corporation whose shares were being traded fared worse, despite the fact that the federal law still provided no equivalent remedy.⁸⁷ *Diamond* was never overruled in New York, but it became dormant. Similarly, *Brophy* was on occasion acknowledged to be good law in Delaware during this period, but its development remained in abeyance.⁸⁸

As noted above, there are strong common law bases for the *Diamond* approach to insider trading grounded in principles of fiduciary duty, as well as agency, trusts, and restitution.⁸⁹ Nevertheless, it was resoundingly rejected in the only two cases that squarely involved the issue during the decade following its promulgation and the contemporaneous *Texas Gulf Sulphur* decision. The approach first surfaced in *Schein v. Chasen*,⁹⁰ a series of cases involving complications both in fact pattern and in procedural posture. Originally certain stockholders of Lum's, Inc., a Florida corporation, brought a derivative action against the corporation's president and a series of tippees in the federal courts of New York under diversity jurisdiction. Essentially Chasen, Lum's president, had informed an employee of a stockbroker that Lum's earnings would be lower than previously projected. In turn the employee informed certain mutual funds who sold their shares prior to the public announce-

81. *Id.* at 848.

82. Even as *Texas Gulf Sulphur* was being decided, 49 private actions were already pending in the district court. *Id.* at 866. For a more complete analysis of the federal insider trading cases, which is beyond the scope of this Article's treatment of the common law regulation, see L. Loss, *supra* note 52, at 799-944.

83. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

84. See § 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) (1982).

85. L. Loss, *supra* note 52, at 820.

86. *But see* *Lazenby v. Godwin*, 40 N.C. App. 487, 253 S.E.2d 489 (1979).

87. The implied right of action under § 10(b) and rule 10b-5 is available only to purchasers or sellers of securities. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). A corporation would have standing under rule 10b-5, directly or through a derivative suit, however, in the event the corporation actually purchased or sold its securities; but it is difficult to imagine this posture in an insider trading case.

88. *Thomas v. Roblin Indus.*, 520 F.2d 1393, 1397 (3d Cir. 1975) (applying Delaware law); *Cambridge Fund, Inc. v. Abella*, 501 F. Supp. 598, 630-32 (S.D.N.Y. 1980) (applying Delaware law); *Davidge v. White*, 377 F. Supp. 1084, 1088 (S.D.N.Y. 1974) (applying Delaware law); see also some positive mention of the *Brophy* or *Diamond* approach in *Jennings v. Roberts Scott & Co.*, 113 Ariz. 57, 59, 546 P.2d 343, 345 (1976); *Katz Corp. v. T.H. Canty & Co.*, 168 Conn. 201, 211, 362 A.2d 975, 980 (1975); *but see* *Equity Corp. v. Milton*, 42 Del. Ch. 425, 432-33, 213 A.2d 439, 443 (1965), *aff'd*, 43 Del. Ch. 160, 221 A.2d 494 (1966).

89. See *supra* notes 57-64 and accompanying text. See also *Hazen*, *supra* note 17, at 848.

90. *Schein* involved a number of cases: *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973), *judgment vacated sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974), *certif. question answered sub nom. Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975).

ments. All persons in the chain of tipping and trading were aware that the adverse information was not yet public.⁹¹

The Court of Appeals for the Second Circuit, relying on and extending to tippees the *Diamond* approach, held that under Florida law all of the defendants, as part of a "common enterprise," were accountable to the corporation for the profits, *i.e.*, the losses avoided from trading on the inside information.⁹² One of the three judges dissented on the merits of extending the *Diamond* fiduciary duty concept to tippees and further argued that the question should have been certified to the Florida Supreme Court.⁹³ The United States Supreme Court agreed with the latter point and so remanded the case.⁹⁴

The Florida Supreme Court addressed the liability of the tippees only, relegating to dicta its wholesale rejection of the *Diamond* approach. Yet the court's language cannot be completely ignored. After endorsing Judge Kaufman's dissenting view that the tippees, unlike the corporation's officers, directors, employees, or agents, had no fiduciary obligation to Lum's,⁹⁵ the court went on to reject not only the liability of the tippees, but also the entire principle enunciated in *Diamond*.⁹⁶ The immediate stated reason was that some actual damage to the corporation was an essential element for a stockholder's derivative action in Florida.⁹⁷ Although the court took "note with interest" that the Commission had also filed an enforcement action under section 10(b) and rule 10b-5 against all of the defendants,⁹⁸ it is difficult under the circumstances of a limited certified question to infer in what manner the federal action actually influenced, if at all, the court's view of the *Diamond* approach.

The more major set-back for the future of the *Diamond* approach came in 1978 when it was again rejected, this time by the Court of Appeals for the Seventh Circuit applying Indiana law. *Freeman v. Decio*,⁹⁹ unlike *Schein*, did not involve a possible extension of the *Diamond* approach, but simply its possible adoption in a typical case of insider trading by officers and directors. Once again, the plaintiff shareholder of Skyline Corporation, whose stock was publicly traded, alleged that three directors, including one who was also the chief executive officer and the largest shareholder of Skyline, became aware of a reduction in anticipated earnings and without any public disclosure sold Skyline stock in order to reduce their losses. The court considered squarely whether the Indiana courts would adopt the *Diamond* approach or join the Florida Supreme Court's rejection of the principle that a corporation is entitled to recover from its fiduciaries who trade based on inside information.¹⁰⁰ Although it admitted that the question was a "close one," the court concluded that the Indiana

91. *Schein v. Chasen*, 478 F.2d 817, 820 (2d Cir. 1973), *judgment vacated sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974).

92. *Id.* at 822.

93. *Id.* at 825-29 (Kaufman, J., dissenting).

94. *Lehman Bros. v. Schein*, 416 U.S. 386 (1974).

95. *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975).

96. *Id.* at 746.

97. *Id.*

98. *Id.* at 746-47.

99. 584 F.2d 186 (7th Cir. 1978).

100. *Id.* at 189.

courts would refuse to adopt what it characterized as the New York court's "innovative ruling."¹⁰¹

In light of the current importance of state common law regulation of insider trading,¹⁰² the reasoning of the *Freeman* decision must be carefully examined. Although the court indicated that "it is widely accepted that insider trading should be deterred because it is unfair to other investors who do not enjoy the benefits of access to inside information,"¹⁰³ it also noted that the "goal of 'market egalitarianism' may be costly."¹⁰⁴ Ultimately, its balance in favor of rejecting the *Diamond* approach seemed to be based on its view, quite the opposite from that of the New York Court of Appeals, that the existing remedies, primarily federal, for controlling insider trading were adequate. Focussing on the dicta in *Diamond*, the Seventh Circuit pointed to a possible recovery for the corporation under section 16(b) of the Exchange Act,¹⁰⁵ a possible action by the Commission primarily under rule 10b-5 for a variety of remedies,¹⁰⁶ a possible action by the "victims" of insider trading under state law,¹⁰⁷ and most important, the likelihood of actions by the "victims" under the rule 10b-5 private right of action.¹⁰⁸ As to the last, the court took note of the fact, correct at the time, that many of the elements of common law fraud, such as "privity, reliance, and the distinction between misrepresentation and non-disclosure"¹⁰⁹ and causation¹¹⁰ had been significantly relaxed, making the rule a favorite and effective vehicle for damage suits against insider traders.¹¹¹ While the circuit court went on to discuss other difficulties with the *Diamond* approach,¹¹² the essence of the decision was disagreement with the New York court's view that its result was necessary to supplement the then inadequate federal law regulation of insider trading. In light of the decreased adequacy of the federal remedies following the United States Supreme Court's decisions in *Chiarella* and *Dirks*,¹¹³ the reasoning underlying *Freeman*, as opposed to that underlying *Diamond*, is today at best dubious.

D. The Time of Resurgence

Throughout the years during which the various federal courts broadly construed the remedy under section 10(b) and rule 10b-5 in order to deter insider trading to the greatest extent possible, the Supreme Court never directly addressed the issue of whether all or only some persons are subject to the disclose or abstain from trading

101. *Id.* at 196.

102. See *infra* text accompanying notes 142-44.

103. *Freeman v. Decio*, 584 F.2d 186, 189 (7th Cir. 1978).

104. *Id.* at 190.

105. *Id.*

106. *Id.*

107. *Id.* at 191.

108. *Id.*

109. *Id.*

110. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); but see *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

111. *Freeman v. Decio*, 584 F.2d 186, 191 (7th Cir. 1978).

112. See *id.* at 192-96.

113. See *infra* text accompanying notes 120-41.

and tipping rule.¹¹⁴ It did, however, narrow the scope of the rule 10b-5 private right of action generally by "tightening up" the previously "watered down" elements of privity,¹¹⁵ materiality,¹¹⁶ and scienter,¹¹⁷ as well as by removing from the federal sphere activities not clearly "manipulative" or "deceptive" under a narrow construction of those section 10(b) terms.¹¹⁸ The blows dealt to the federal regulation of insider trading by the United States Supreme Court in *Chiarella* and again in *Dirks* were, therefore, no surprise.

As stated above, the Court of Appeals for the Second Circuit in *Texas Gulf Sulphur* based its conclusion that all possessors of inside information have a duty to disclose or not trade or tip on the principle that all investors should have equal access to all material information.¹¹⁹ In its 1980 decision in the case of *Chiarella v. United States*,¹²⁰ the Supreme Court rejected both that principle and its underlying analysis. *Chiarella* involved the activities of a printer, a "markup man" in the offices of Pandick Press, a regularly used New York City financial printer.¹²¹ *Chiarella*, an apparently sophisticated person, was able to deduce the names of target companies in forthcoming tender offers based on the offering materials despite the use of code names. He then purchased the securities and resold them at substantial premiums.¹²² The Commission, after discovering this pattern of events, took action against *Chiarella* successfully¹²³ until the enforcement action reached the Supreme Court in the context of a criminal proceeding. In that context, the Supreme Court decided that *Chiarella* had not violated section 10(b) and rule 10b-5 because he had no duty to disclose the inside information to the sellers of the target companies' securities.

The Court stated unequivocally that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information,"¹²⁴ and more specifically that:

No duty could arise from [*Chiarella's*] relationship with the sellers of the target company's securities, for [*Chiarella*] had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.¹²⁵

114. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Supreme Court did conclude that the defendant bank and two of its individual employees were liable for the Ute's losses because, among other things, they possessed an affirmative duty to disclose that they were market makers in the securities involved and were using their long-standing position of trust for their own financial gain. *Id.* at 152-53.

115. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); see also *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

116. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976).

117. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

118. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

119. See *supra* notes 80-81 and accompanying text. The Second Circuit repeated the same conclusion to uphold *Chiarella's* conviction. *Chiarella v. United States*, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

120. 445 U.S. 222 (1980).

121. *Id.* at 224.

122. *Id.*

123. *SEC v. Chiarella*, No. 77-2534 (S.D.N.Y. May 24, 1977), *motion to dismiss denied*, 450 F. Supp. 95 (S.D.N.Y.), *aff'd*, 588 F.2d 1358 (2d Cir. 1978), *cert. granted*, 441 U.S. 942 (1979).

124. *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

125. *Id.* at 232-33.

Referring often to the "common law,"¹²⁶ the Court saw no state law fiduciary duty owed by Chiarella to the persons from whom he purchased securities.¹²⁷ In addition, while endorsing the holding of *Cady, Roberts*,¹²⁸ the Court saw no such duty of "trust and confidence"¹²⁹ that arose from

(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.¹³⁰

Chiarella remains confusing. If a common law duty was essential, as it appears to have been, the possible sources of any such duty remain unclear. While probably a majority of states now recognize a common law duty of disclosure to shareholders of a corporation by its trading officers and directors,¹³¹ that duty would never extend to the *Chiarella* fact pattern.¹³² In addition, while Chief Justice Burger suggested that the duty to disclose requirement was satisfied by Chiarella's misappropriation of information in violation of a duty to his employer, Pandick Press,¹³³ that basis for a duty to disclose was not addressed by the Court in *Chiarella* nor in the later case of *Carpenter v. United States*¹³⁴ involving the same issue.

Three years following its decision in *Chiarella*, the Supreme Court again addressed the duty to disclose requirement for rule 10b-5 liability for insider trading, this time in the context of a tippee of inside information. In the case of *Dirks v. SEC*,¹³⁵ Dirks, an officer of a broker-dealer specializing in providing investment analysis to institutional investors, was informed by Secrist, a former officer of Equity Funding, that the assets of the corporation were "vastly overstated"¹³⁶ as a result of a fraudulent scheme. Dirks proceeded to investigate the matter and in the course of doing so openly discussed the alleged fraud with a number of investors, some of whom relied on the information in selling their shares of Equity Funding. The Supreme Court found Dirks not liable for tipping the material inside information because it concluded that he had no pre-existing duty to disclose before trading or tipping.¹³⁷ Again the Court emphasized that a duty arises not from "the mere possession of nonpublic market information,"¹³⁸ but rather from the existence of a

126. See *id.* at 227, 229; see also *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 436 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988) (a former shareholder employee of a corporation brought an action against the corporation for fraud in inducing the plaintiff to sell his stock; the court found that closely held corporations must disclose material information to investors from whom it purchases stock); Hazen, *supra* note 17, at 851.

127. *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

128. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 913 & n.21 (1961).

129. *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

130. *Id.* at 227 (citing with approval *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 & n.15 (1961)).

131. See *supra* note 53 and accompanying text.

132. As indicated above, the common law duty to disclose has been limited to face-to-face transactions and has not been extended to stock exchange transactions. See *supra* note 56 and accompanying text.

133. *Chiarella v. United States*, 445 U.S. 222, 240-43 (1980) (Burger, C.J., dissenting).

134. 108 S. Ct. 316 (1987). The Court had before it the misappropriation of information issue; however, it avoided the question by finding liability based on a violation of the mail frauds statute. The Court's 4-4 split on the misappropriation theory as a basis for a federal law duty to disclose leaves the issue in doubt. See generally Aldave, *supra* note 16.

135. 463 U.S. 646 (1983).

136. *Id.* at 649.

137. *Id.* at 654.

138. *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 235 (1980)).

fiduciary relationship.¹³⁹ In the case of a tippee like Dirks, any such duty could be derived from Secrist's duty,¹⁴⁰ but only if Secrist had breached his duty by disclosing the information. Since Secrist received no personal benefit from tipping Dirks, he breached no duty and therefore, the Court reasoned, Dirk's acquired no derivative duty.¹⁴¹

It is now clear that insider trading constitutes a violation of section 10(b) and rule 10b-5 only if the trader has a common law duty to speak. The legal sources of such a duty have therefore become crucial. While the courts could look to a federal common law, it is more likely that "[t]he obligation to break silence is itself based on state law,"¹⁴² the duty normally being the fiduciary duty of corporate law.¹⁴³ In light of the renewed importance of any relevant state law duty to disclose or refrain from insider trading, it is likely that the existing state law will undergo at least substantial redefinition¹⁴⁴ and almost certainly some expansion. Otherwise, any effective future regulation of insider trading under either federal or state law will be impossible.

As explained above, corporate officers and directors and controlling shareholders in most, if not all, states have a duty to disclose material nonpublic information in a face-to-face transaction.¹⁴⁵ That duty could be expanded to include employees, tippees, and various other persons; and it could be extended to apply to transactions over the exchanges. Such changes would broaden the remedy for the defrauded investors on both the federal and state level. Yet large numbers of suits by individuals who traded are unlikely given the difficulties of establishing all of the elements of a rule 10b-5 or state common law cause of action.¹⁴⁶ Also, while an expanded state law duty to disclose running to investors would satisfy the Commission's need for a duty to enable it to vigorously combat insider trading, the Commission's resources are limited.¹⁴⁷ A much more effective and desirable weapon against insider traders is that selected by the New York Court of Appeals in *Diamond*.¹⁴⁸ If the *Diamond* approach were to be extensively recognized and perhaps expanded, that state law duty of disclosure owed to the corporation would make a rule 10b-5 action available to the

139. *Id.*

140. *Id.* at 655.

141. *Id.* at 661-67.

142. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 436 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988); *see also Hazen, supra* note 17, at 851-52.

143. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987), *cert. dismissed*, 108 S. Ct. 1067 (1988).

144. *Id.* at 436.

145. *See supra* text accompanying notes 53-56.

146. *See supra* notes 115-18 and accompanying text.

147. Between 1974 and 1976, the National Association of Securities Dealers reported 186 suspected insider trading cases to the Commission. Only 20% were investigated, and in only one in sixty was an actual action brought. *See Flood of Insider Trading Referrals to SEC Results in Trickle of Investigations, Lawsuits*, Sec. Reg. & L. Rep. (BNA) No. 412, at A-4, A-5 (July 20, 1977). The situation has not improved. Senate Banking Securities Subcommittee Chairman Donald Riegle (D-Mich.) recently noted that while reports indicate "explosive growth in securities trading," there continues to be a lack of funds for SEC market regulation and investment management staff. *See More Inside Trading Cases by This Summer, Shad Predicts*, Sec. Reg. & L. Rep. (BNA) No. 19, at 704 (May 15, 1987). For further description of the extent to which the Commission has been able to deter insider trading through enforcement actions, *see Bainbridge, The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 40-43 (1986); Note, *A Critique of the Insider Trading Sanctions Act*, *supra* note 2, at 466-67.

148. *See supra* text accompanying notes 63-69.

Commission and to the defrauded investors. But, more important would be the powerful weapon of the derivative suit by which the shareholders of the corporation involved could vigorously and effectively deter insider trading, at least by traditional insiders and perhaps others, to the benefit of the corporation's reputation and the integrity of the markets for its securities.

Fortunately, the resurgence of the *Diamond* approach is at hand. Although that approach has been considered by only a few courts since its original adoption, it continues to be the law in New York and Delaware. Indeed, albeit without particular discussion, it has been recognized as the law of Delaware subsequent to the *Chiarella* decision.¹⁴⁹ The wave of the future, however, was foreshadowed by the very recent case of *In re Orfa Securities Litigation*,¹⁵⁰ in which the United States District Court for the District of New Jersey concluded that under New Jersey common law there was a derivative cause of action available against four individual corporate officers¹⁵¹ who traded without disclosing material nonpublic information.¹⁵² The stock of Orfa Corporation was trading on the national over-the-counter market. The defendant officers knew that various public documents contained inaccurate favorable information about the corporation which had the effect of inflating the price of its stock. Without disclosing such inaccuracies, they sold over a four-month period considerable amounts of stock. When the true state of affairs became public, the price of the stock, of course, immediately plummeted.¹⁵³

After reviewing the status of the *Diamond* approach in those four states where the courts had addressed the issue, the district court with little "ado" adopted it as a reasonable application of the basic proposition that a corporate fiduciary "may not exploit inside information for personal gain"¹⁵⁴ to the insider trading situation.¹⁵⁵ Like the court in *Freeman*, however, the court held harm to be a necessary element of a breach of fiduciary duty claim.¹⁵⁶ Unlike the *Freeman* court, though, the *Orfa* court appeared to anticipate that harm to the corporate goodwill would be adequate and probably provable.¹⁵⁷

V. THE FUTURE OF THE COMMON LAW REGULATION

The effective regulation of insider trading, in part because of the *Chiarella* and *Dirks* decisions,¹⁵⁸ is in a state of disarray. Under section 10(b) and rule 10b-5, there is now a federal remedy only if the insider trader had a fiduciary duty to disclose or

149. *Fausett v. American Resources Management Corp.*, 542 F. Supp. 1234, 1240 (D. Utah 1982); see also *supra* note 88.

150. 654 F. Supp. 1449 (D.N.J. 1987).

151. Each individual officer also owned between 10% and 15% of the corporation's outstanding stock. Accordingly, there may have also been a duty to disclose resulting from their status as controlling shareholders either as individuals or as a group *Id.* at 1451.

152. *Id.* at 1455.

153. The corporation's stock price dropped 50% in just a three-day period over the weekend. *Id.* at 1452-53.

154. *Id.* at 1456.

155. *Id.*

156. *Id.* at 1457.

157. *Id.* at 1457-58.

158. See *supra* text accompanying notes 120-41.

refrain from trading or tipping. At the same time, however, the state law development of the scope of fiduciary duty in the insider trading area had been "aborted"¹⁵⁹ by the then seemingly adequate federal remedies. Yet today, the desire to curb insider trading has become a top priority with the President,¹⁶⁰ with Congress,¹⁶¹ with state legislatures,¹⁶² with a majority of commentators,¹⁶³ and, albeit guardingly according to the *Freeman* court, with most courts.¹⁶⁴ While no solution in the absence of perhaps specific legislation will address the problem as broadly as is called for, widespread adoption and expansion of the *Diamond* approach will and should effectively deter a very substantial amount of insider trading. For various reasons, that result is both likely and desirable.

A. The Soundness of the Diamond Approach

The recognition of the *Diamond* approach is consistent with, if not mandated by, the constantly evolving corporate law of fiduciary duty. Under that state law, the duty to disclose at least in Delaware has expanded to the point where it now dominates the law of fiduciary duty in a variety of transactions.¹⁶⁵ Indeed, it can easily be stated today that "disclosure and fiduciary duty are inextricably intertwined."¹⁶⁶

This "shift to a disclosure-based standard of fiduciary duty,"¹⁶⁷ while perhaps only recently culminating in Delaware, is neither novel nor unexpected. The duty to disclose has long been a part of a fiduciary's obligations to his corporation. For example, in *Zahn v. Transamerica Corp.*,¹⁶⁸ the Court of Appeals for the Third Circuit held that a majority stockholder breached its duty by causing the redemption of certain convertible securities instead of permitting those securityholders to share

159. See L. Loss, *supra* note 52, at 820.

160. See *supra* note 2.

161. *Id.*

162. A number of state legislatures, in light of *Chiarella* and *Dirks*, have amended their state blue sky laws to broaden the remedies available against insider traders. For example, the California Corporate Code directly addresses insider trading:

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling or buying from him is also in possession of the information.

CAL. CORP. CODE § 25405 (West 1977 & Supp. 1988). New Mexico has recently enacted a similar law which became effective on July 1, 1986. N.M. STAT. ANN. § 58-13B-32 (1987). See also PA. STAT. ANN. tit. 70, § 1-406 (Purdon Supp. 1984-85); WASH. REV. CODE ANN. § 21.20.480 (West 1978 & Supp. 1988).

Additionally, courts have begun to construe the state blue sky laws broadly as a further possible deterrent to insider trading. See e.g., Olson, *The California Corporate Securities Law of 1968*, 9 SANTA CLARA LAW. 75 (1968); Comment, *Proof of Fault in Actions for Securities Fraud: A Cloud in Pennsylvania's Blue Sky*, 46 U. PITT. L. REV. 1083 (1985); Casenote, *Blue Sky Law - New York Blue Sky Law Antifraud Provision Used to Impose Criminal Liability on Attorney Who Engaged in Insider Trading*, 13 U. BALT. L. REV. 631 (1984).

163. See *supra* note 19.

164. *Freeman v. Decio*, 584 F.2d 186, 191 (7th Cir. 1978).

165. See generally Booth, *supra* note 34.

166. *Id.* at 103. Of course, sometimes the fiduciary duty is to maintain the confidentiality of information in order to accomplish a legitimate corporate purpose. See, e.g., *supra* note 80.

167. Booth, *supra* note 34, at 78-79.

168. 162 F.2d 36 (3d Cir. 1947).

in the forthcoming liquidation of the corporation.¹⁶⁹ As the ultimate award of damages made clear,¹⁷⁰ the nature of the breach was not *effecting* the transactions, but rather *failing to disclose* that the redemption would be followed by liquidation to enable those securityholders to exercise their conversion rights and thereby share in the assets upon liquidation of the corporation.

Somewhat more recently, in the context of a majority stockholder's tender offer to purchase all of the outstanding minority stock,¹⁷¹ the Delaware Supreme Court concluded that the majority stockholder and its directors had breached their fiduciary duty of "complete candor" by failing to disclose "all information in their possession germane to the transaction."¹⁷² Most recently, the Delaware Supreme Court took an enormous step in expanding the fiduciary duty to disclose when it decided *Weinberger v. UOP, Inc.*¹⁷³ in 1983. *Weinberger* involved a merger of a subsidiary into the parent corporation in which the minority stockholders were "cashed out." Again, the court based its decision that the parent had breached its fiduciary duty¹⁷⁴ on its failure to disclose to the minority stockholders all information relevant to the fairness of the merger price.¹⁷⁵ Finally, in the very recent case of *Smith v. Van Gorkom*,¹⁷⁶ involving the sale of all of the assets of a corporation for cash, the Delaware Supreme Court focussed on the inadequacy of disclosure in the proxy materials and refused to give any effect to what it regarded as an uninformed stockholder vote.¹⁷⁷

The duty owed to a corporation by traditional insiders has become at least in Delaware largely a duty of disclosure, a duty requiring arguably more information than would satisfy the materiality standard under federal law. This expanded duty to disclose has been characterized by the Delaware Supreme Court itself as merely another way of recognizing "the long-existing principle of Delaware law that . . . [fiduciaries] owed . . . an uncompromising duty of loyalty."¹⁷⁸ As one commentator recently noted, the courts "appear to be more willing to find directorial breaches than ever before."¹⁷⁹ Accordingly, widespread endorsement and expansion of the *Diamond* approach, involving the recognition of a broad duty owed to the corporation to disclose or refrain from insider trading or tipping, is almost certainly at hand.¹⁸⁰

169. *Id.* at 46.

170. *Speed v. Transamerica Corp.*, 235 F.2d 369, 374 (3d Cir. 1956).

171. *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977).

172. *Id.* at 281.

173. 457 A.2d 701 (Del. 1983).

174. *Id.* at 703.

175. *Id.* at 709.

176. 488 A.2d 858 (Del. 1985).

177. *Id.* at 874-78, 889-93.

178. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

179. Booth, *supra* note 34, at 78 & n.41; *see also* Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981) (recognition of a more expanded fiduciary duty in the reinsurance industry under New Jersey law).

180. While other remedies are possible given the broad equitable discretion of the state courts, disgorgement as provided by *Diamond* for the benefit of the corporation is most appropriate since the breach is based on the unfairness of the gain rather than on direct harm to the corporation. *See Hazen, supra* note 17, at 859 & n.95.

B. *The Benefits of the Diamond Approach*

The continued adoption and development of the *Diamond* approach should occur because of the many advantages and benefits surrounding this method of regulating insider trading. As stated above, if under state law a person, such as a traditional insider, an employee, or even a tippee,¹⁸¹ has a fiduciary duty to the corporation to disclose or refrain from insider trading, that state law duty will satisfy the federal requirement of a fiduciary duty under rule 10b-5.¹⁸² The more significant advantages of the approach, however, derive from the state law remedy itself. Most important, the corporation whose shares are traded will finally be able to take enforcement actions against insider traders.¹⁸³ Simply put, as the number of possible plaintiffs, and consequently the number of actions against insider traders, increase, the goal of deterring the practice will be increasingly achieved.

Also noteworthy is the likelihood that the corporation may be a more zealous and effective policer of insider trading.¹⁸⁴ Unlike others it has several powerful incentives to sue insider traders. As mentioned in *Diamond*,¹⁸⁵ perceived or actual insider trading may injure the corporation's reputation, which could in turn affect its ability to raise capital, to attract customers or employees, or otherwise adversely affect the corporation's ability to conduct business successfully in ways perhaps not yet anticipated. In addition, individual officers and directors who become aware of insider trading will likely take action against the culprits to avoid the possibility of breaching their own duties of due care by failing to pursue the matter on behalf of the corporation.¹⁸⁶ Finally, since corporate officers are closer to trading activities in the corporation's stock and to any not yet disclosed material information about the corporation, they are perhaps more likely than the Commission or individual investors to detect particular insider trading activities.¹⁸⁷

Of most importance in terms of the long term effective regulation of insider trading is that the cause of action available to the corporation will and should be a more powerful weapon than any of the alternatives under the existing state or federal law. The gravamen of the fiduciary's typical violation is trading on the basis of nonpublic material information itself, nothing more. Accordingly, once the corporation establishes that the insider trader is a fiduciary and that he traded without disclosing the information of which he was aware or perhaps should have been aware,¹⁸⁸ the result is clear. Presumably there should be no need to establish other

181. See *infra* text accompanying notes 193-99.

182. See *supra* text accompanying notes 142-48.

183. The nontrading corporation has no standing to utilize any other remedy except, in some circumstances, that contained in § 16(b) of the Exchange Act. See *supra* notes 21-22, 35 & 87.

184. See generally Comment, *Inside Information and Outside Traders*, *supra* note 2, at 513-16.

185. See *supra* note 66.

186. Comment, *Inside Information and Outside Traders*, *supra* note 2, at 514 & nn. 167-68.

187. *Id.* at 515.

188. Since scienter is normally not required to establish a breach of fiduciary duty, the courts could and likely would impose liability on a fiduciary who traded while negligently believing the confidential information had become public. See *supra* note 37; see also *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 (Del. 1983).

elements, such as causation or actual damages.¹⁸⁹ Furthermore, to the extent there are issues of fact, it seems likely and appropriate that, given the inherent conflict of interest involved, the burden of proof should and will be on the alleged insider trader.¹⁹⁰

Finally, there is reason to believe that the *Diamond* approach will also be construed to provide the corporation with a remedy against insider traders who are not traditional insiders. Those categories of persons who owe a fiduciary duty to refrain from insider trading under state law can be expanded, regardless of the *Chiarella* and *Dirks* decisions under federal law. The extent of such judicial expansion of the *Diamond* approach will depend on the various courts' views of how far the regulation of insider trading should go. As *Brophy* suggests,¹⁹¹ the duty could easily be extended to employees of the corporation, even temporary employees such as lawyers, accountants, and others who because of their services to the corporation, acquire nonpublic information.¹⁹² In the event that a state's policy is to curb insider trading to the fullest extent possible, a strong argument can be made that tippees of corporate fiduciaries are also subject to the fiduciary duty to refrain from insider trading and would be liable to the corporation for any profits resulting from the violation of that duty. Indeed, in its decision in *Schein v. Chasen*,¹⁹³ the Court of Appeals for the Second Circuit extended the *Diamond* approach to hold liable a corporate officer, a tipped and tipper employee of a stockbroker, the stockbroker, and several tippee investors, in sum the entire chain of tippers and tippees.¹⁹⁴ The basis for imposing the fiduciary duty of a traditional insider on those outsiders was the court's finding that they were involved with "directors in a common enterprise to misuse confidential corporate information for their own enrichment."¹⁹⁵ As to the meaning of "common enterprise," the court implied that it could be presumed from "the sequence of events."¹⁹⁶ While some would take issue with the soundness of the articulated basis for the court's extension of the *Diamond* approach to tippees,¹⁹⁷ it is certainly, as the majority noted, consistent with the policy of "tightening the law of insider trading."¹⁹⁸ Should that be the goal, state courts could and should utilize the *Diamond* approach as extended by the Second Circuit. If that court's view is widely endorsed, the state law has the potential to regulate nearly all insider trading as defined for purposes of this Article.¹⁹⁹

189. *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 247, 70 A.2d 5, 8 (1949); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969); but cf. *In re Orfa Secs. Litig.*, 654 F. Supp. 1449, 1457 (D.N.J. 1987).

190. See *supra* note 39.

191. *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 245, 70 A.2d 5, 8 (1949).

192. In fact, the Commission has used the constructive or temporary insider theory, first mentioned by the Supreme Court in *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983). See, e.g., *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983) (a friend of a corporate insider, because of his relationship with the insider, was held a temporary insider and had to disgorge profits obtained from possessing material, nonpublic information).

193. 478 F.2d 817 (2d Cir. 1973), judgment vacated *sub nom.* *Lehman Bros. v. Schein*, 416 U.S. 386 (1974).

194. *Id.* at 820.

195. *Id.* at 822.

196. *Id.*

197. Judge Kaufman dissented to extending *Diamond* to tippees. *Id.* at 825 (Kaufman, J., dissenting).

198. *Id.* at 823.

199. See *supra* text accompanying note 24.

C. *The Problems with the Diamond Approach*

Although the *Diamond* approach is much in tune with current state court views of the fiduciary duty of complete disclosure, and while it is capable of providing the most extensive and effective regulation of insider trading, its endorsement and expansion are not without certain problems. Upon further examination of those so-called problems, pointed out primarily in the *Schein*²⁰⁰ and *Freeman*²⁰¹ decisions, it appears that they are on balance both manageable and much overshadowed by the several benefits of the *Diamond* approach to the regulation of insider trading as outlined above.²⁰²

The Florida Supreme Court in *Schein* rejected the *Diamond* approach because it concluded that actual harm to the corporation is an essential element for a stockholder's derivative suit in Florida.²⁰³ In those jurisdictions where such is the law, one possible solution is a broad construction of what constitutes "harm" to the corporation in the context of insider trading. Indeed, that approach was the one taken by the district court in the recent *Orfa* decision making the *Diamond* approach the present law in New Jersey.²⁰⁴ Furthermore, the existence of harm, or a provable amount of harm, to the corporation is not essential to a state court's ability to fashion a suitable remedy. Courts of equity have traditionally been able to fashion suitable remedies,²⁰⁵ including the disgorgement of profits, that is rescissory damages,²⁰⁶ an accounting based on a constructive trust theory,²⁰⁷ and even damage awards unrelated to the amount of harm caused by the particular breach of fiduciary duty.²⁰⁸ Even were a court to limit the damages to only those that were actually established, a recognition of nothing more than nominal damages would support a further award of punitive damages,²⁰⁹ presumably an effective and perhaps generally desirable mechanism for deterring insider trading.

A second problem considered in both *Schein*²¹⁰ and *Diamond*²¹¹ was the

200. See *supra* discussion of *Schein* in text accompanying notes 95-98.

201. See *supra* discussion of *Freeman* in text accompanying notes 99-112.

202. See *supra* text accompanying notes 181-99.

203. See *supra* note 97.

204. *In re Orfa Secs. Litig.*, 654 F. Supp. 1449, 1457 (D.N.J. 1987).

205. Since *Weinberger*, the courts in Delaware have complete flexibility to consider "all factors" in arriving at the proper amount of damages or some other remedy appropriate to the breach of fiduciary duty involved. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983).

206. See, e.g., *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 502 (Del. 1981).

207. See, e.g., *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

208. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court found the Trans Union shareholders entitled to damages "to the extent that the fair value of Trans Union exceeds [the cash-out price of] \$55 per share." *Id.* at 893. Testimony by the plaintiff's financial experts valued Trans Union's shares from \$65-\$70 per share. Although remanded to the Chancery Court (if the shares were found to be worth \$60 per share, the recovery would amount to approximately \$65 million), the case was settled out of court for \$23.5 million. Only \$10 million was covered by the directors' liability insurance; the rest was paid by the purchasing group (although they were not legally obliged to do so). See Schatz, *Focus on Corporate Boards: Directors Feel the Legal Heat*, N.Y. Times, Dec. 15, 1985, at 13, col. 1.

209. Note, *The Availability of Variant State Remedies for Pending State Fraud Claims Actionable Under the Federal Securities Acts*, 47 S. CAL. L. REV. 1213, 1216-18 (1974). Punitive damages are not an option in the case of a rule 10b-5 case. T. HAZEN, *THE LAW OF SECURITIES REGULATION* 741 (1985). See generally Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985); Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984).

210. *Schein v. Chasen*, 478 F.2d 817, 824-25 (2d Cir. 1973).

211. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 504, 248 N.E.2d 910, 915-16, 301 N.Y.S.2d 78, 86 (1969).

possibility that an insider trader, if liable under the *Diamond* approach, could theoretically be subject to double or even triple liability for the same conduct. Double liability could result in the event that the corporation recovered under the *Diamond* approach and defrauded purchasers were successful in recovering under rule 10b-5. In certain cases, it is also conceivable that the corporation could recover short-swing profits under section 16(b).²¹² Once again, the "problem" can be managed in a number of ways. In light of the fact that the purpose of both the federal and state law remedies is to deter insider trading, the simplest and most desirable approach would be to recognize that insider trading involves the "possibility of two distinct harms here, one to the corporation and one to the shareholders"²¹³ that are both deserving of a remedy.²¹⁴ While other solutions exist,²¹⁵ among them the possibility of the corporation's holding the profits in escrow for the benefit of any successful defrauded traders,²¹⁶ they are less desirable. The right of the corporation is not necessarily less worthy than the rights of individual investors. Finally, there is little question that the threat of losing only the profits that an insider trader unlawfully gained is in fact no deterrence at all. An ideal correction for that problem would be the threat of liability for two or even three times the amount of the unlawful profits.²¹⁷

Finally, some have argued that since the states will vary in deciding whether and to what extent to adopt the *Diamond* approach, the differences in the state common law will preclude uniformity in actions brought under section 10(b) and rule 10b-5.²¹⁸ That problem, however, is unrelated to whether the *Diamond* approach is necessary or desirable. It was created by the United States Supreme Court when it chose to inject the common law into the federal remedy. Indeed, the Supreme Court itself has recently held that the Constitution does not require uniform regulation or endorsement of uniform theories of regulation;²¹⁹ and that ruling was in the context of upholding a state anti-takeover statute, one in fact at least arguably inconsistent with, if not actually

212. See *supra* note 22.

213. The *Orfa* court took this approach. *In re Orfa Secs. Litig.*, 654 F. Supp. 1449, 1458 (D.N.J. 1987).

214. *Id.*

215. See generally Note, *Common Law Corporate Recovery*, *supra* note 65, at 289-94.

216. The approach was first suggested and used by the court in *SEC v. Texas Gulf Sulphur*, 446 F.2d 1301, 1307 (2d Cir. 1971).

217. Double damages is not such a novel idea. A number of federal statutes contain treble-damage provisions: notably the Organized Crime Control Act of 1970, title IX of which is the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified at 18 U.S.C. §§ 1961-1968 (1982)). RICO serves broad remedial purposes, providing for treble damages, and fraud in the sale of securities may provide one of the predicate acts of racketeering. 18 U.S.C. § 1964(c) (1982). For articles discussing the use of RICO in securities fraud cases, see Johnson, *Predators Rights: Multiple Remedies for Wall Street Sharks Under the Securities Laws and RICO*, 10 J. CORP. L. 3 (1984); Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291 (1983); Note, *Treble Damages Under RICO: Characterization and Computation*, 61 NOTRE DAME L. REV. 526 (1986); Note, *Application of the Racketeer Influenced and Corrupt Organizations Act (RICO) to Securities Violations*, 8 J. CORP. L. 411 (1983). Since 1970, 27 states have enacted mini-RICOs, 22 of which include the private multiple-damage suit. Blakey, *A Rebuttal to Some of the Myths Spurring Reform Effort in Congress*, Nat'l L.J., Aug. 3, 1987, 26, 28 n.39. Still another treble-damage federal statute pertinent to this Article is the Insider Trading Sanctions Act of 1984. See *supra* note 2.

218. See, e.g., Hazen, *supra* note 17, at 851-52.

219. *CTS Corp. v. Dynamics Corp. of Am.*, 107 S. Ct. 1637 (1987).

contrary to, the federal regulation of tender offers.²²⁰ This problem then, according to the Supreme Court, is not a problem.

VI. CONCLUSION

The need for and the desirable aspects of the *Diamond* approach to the regulation of insider trading clearly dwarf the minor shortcomings associated with its adoption, endorsement, and expansion. The regulation of insider trading has been returned to the state courts after a lengthy period of de facto federal preemption. Those courts' enforcement decisions are critical, their particular competence and experience in matters of fiduciary duty are axiomatic, and the usefulness of some state law differences in the scope of regulation may well provide information helpful in the future to lawmakers who will periodically reevaluate whether, how, and to what extent insider trading should be the subject of federal or state law regulation. Meanwhile, the effective deterrence of insider trading lies with the future of the *Diamond* approach. Accordingly, its widespread expansion is likely to and should be a part of the timely resurgence of state common law regulation of what many regard as the insidious practice of insider trading.

220. Although the Indiana statute would delay some tender offers, the delay was not sufficient to allow preemption by the Williams Act. Indiana's Control Share Act was no more of a delaying tactic for control than, for example, staggered terms for directors or cumulative voting. *Id.* at 1649. "[S]tate regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." *Id.* at 1649. *Cf. Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (Supreme Court struck down an Illinois statute as a direct restraint on interstate commerce). *See generally* Pinto, *Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*, 41 U. MIAMI L. REV. 473 (1987); Comment, *Beyond CTS: A Limited Defense of State Tender Offer Disclosure Requirements*, 54 U. CHI. L. REV. 657 (1987).